

Next Social Contract Initiative and Economic Growth Program

SOCIAL CONTRACT BUDGETING: PRESCRIPTIONS FROM ECONOMICS AND HISTORY

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The Prescriptions, and Their Main Ingredients

If there is to be any durable hope for a social contract that transcends left-right partisanship, that contract must rest upon a majority consensus about policies that are efficient, fair, and sustainable. Once the smoke has cleared from this November's battle over the role of government, what will endure are several policy prescriptions kept alive by an objective reading of economic history and a general consensus among economists.

Economics and history tend to agree on the need for a social contract reflecting different priorities from those implied by the status quo. At this historical juncture, the United States and some other industrialized countries can raise economic growth while reducing poverty and inequality. Among the key strategies are investing more in the young, making social insurance more universal, and shifting to broader and more uniform taxation. This essay argues for these broad strategies, featuring specific recommendations on four fronts:

Education:

- Make increasing public investments in the young, with greater urgency for younger age groups than at the university level.

Health insurance:

- Socialized health insurance works better when it covers everybody.
- Liberate health insurance from jobs, and from bias toward the elderly.

Pensions:

- Keep the share of adult life spent on public pensions from rising, by extending the working age for each benefit rate in proportion to the average adult life expectancy of people with similar career histories.

- Index the retirement benefits for each cohort to that same life expectancy at age 60.
- Index annual pension payouts to recent GDP per working-age person.

Broad taxes:

- The two best candidates are addiction taxes and the value-added tax (VAT), two types successfully applied in virtually all industrialized democracies outside of the United States. These can be progressive as well as pro-growth, as long as they are used to fund universal access to health and education, emphasizing pre-primary education.

Goals of Economic Policy Design

The task of preparing these prescriptions must start with agreement on a modest list of common economic goals, followed by this essay’s proposed budgetary strategies for serving them. I shall focus on the United States, though this country can both import and export some lessons summarized here.

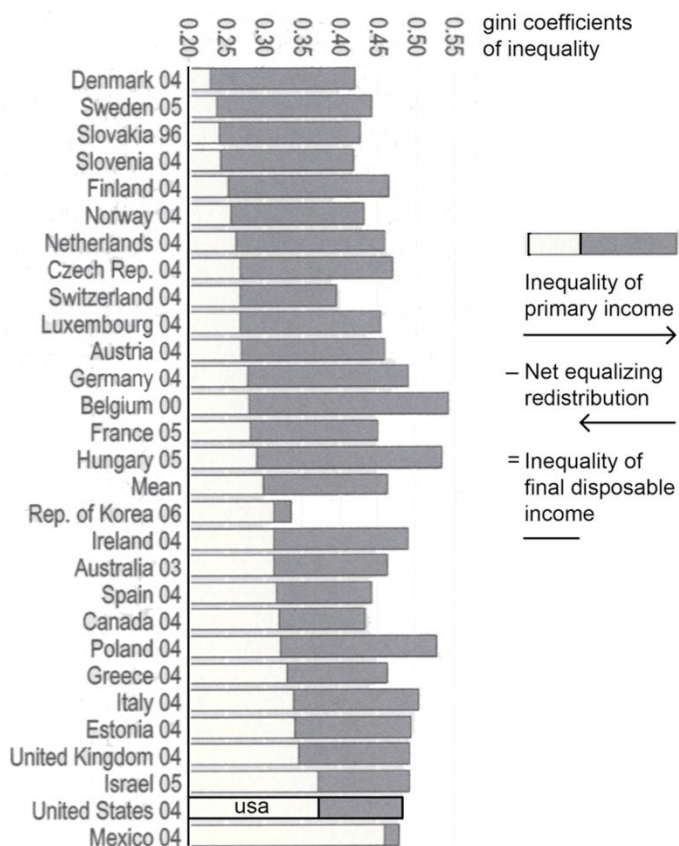
Make only positive-sum policy changes: Raise aggregate material wellbeing.¹

A Hippocratic Oath: Distribute those net positive-sum gains from economic efficiency so that we do no net harm to the share of disposable income going to those below the poverty line.

Among rich industrialized countries, the United States stands out for its income inequality, its reluctance to redistribute from rich to poor, and its share in poverty. The first two of these three distinctions are illustrated by **Figure 1**’s international comparison in inequality and redistribution. Of the 28 OECD countries covered in Figure 1, the United States starts with an above-average inequality of primary income (white bar plus black bar) – that is, the gross income one receives before taxes or transfer payments. While all countries redistribute so as to lower inequality (black bars), the United States, like Mexico and Korea, does little to shift income from rich to poor. As a result, we end up with an inequality of final disposable incomes (white bar) that is second only to that of Mexico. Thus we stand out as an unequal-income country, largely because we do so little about inequality.

The third distinctive performance, our greater share in poverty, is confirmed by recent studies.² This is true on either of two definitions of poverty – relative poverty, meaning the share of the population living in households below half the median income, or absolute poverty, the share living below a real purchasing power defined as the (U.S.) poverty line in a

Figure 1. Inequality and Redistribution in OECD Countries, c 2004



given base year. In terms of absolute poverty, we have a greater share in poverty than most countries, and for children younger than 18 we have the highest share of all the countries studied.³

Our Hippocratic Oath against harming the poor could take any of three forms: (1) avoiding any reduction in their *absolute* real disposable income, (2) avoiding any reduction in their *share* of real disposable income, and (3) redistributing income so that the U.S. poverty share of 17.1 percent drops to the OECD average of 10.6 percent. Economic growth would make the first and lowest standard of the three increasingly unpopular, since it allows income gaps to widen forever. The third of these options, which would target the fact that inequality in the US is extraordinarily high by OECD standards, seems most desirable to this observer, yet must remain only a longer-term goal. Thus, we will use the second standard, ensuring that the policies we choose will not decrease the share of real disposable income of the poorest members of society.

Don't raise the deficit share, except in a slump: Any proposal must be revenue-neutral or deficit-reducing when the economy is not in recession, leaving the deficit no greater as a share of GDP than it is now.

At face value, this goal might seem to reflect some consensus that our current deficits and government debt are already too high in relation to annual GDP. No such consensus exists in the economics profession, however, especially not during slumps.⁴ No economist can quantify the optimal ratio of a deficit or debt to GDP. There is no solid basis for trying to legislate a balanced budget. Furthermore, the wolf is not yet at America's door: our country enjoys more slack in its external credit than do the Mediterranean countries or Japan. Nonetheless, the goal of not adding deficits acknowledges a very long-run constraint: deficits cannot rise faster than GDP forever. Eventually, once the economy has recovered and is on an upward growth path, the United States should start swimming upstream toward surplus to avoid being swept into larger deficits by the increased flow of debt service that higher interest rates will eventually bring.

Four Strategies

These basic goals are well served by four strategies on which economists and a fair reading of modern economic history tend to agree.⁵

Broad is good: Broad-based taxes and broad universalist social expenditures have good incentive effects and promote a sense of even-handedness.

Address externalities: A real-world economy is rife with cases of externalities, in which the costs or benefits of any exchange accrue to third parties, not just to the two parties deciding on the exchange. Economists prescribe tax incentives to offset negative externalities and subsidies or tax forgiveness to encourage positive ones. Again, the prescription is to address the externalities on a broad front, with incentives geared to all sources of the externalities. Let private parties decide how to reduce external-damage activities, like pollution, and how to expand external-benefit activities. Do not presume, for example, that the government knows which specific pollution-control technology needs to be required or subsidized. Similarly, do not presume that it knows what kind of education each individual should have.

Grandfathering is good: People become accustomed to any economic policy regime, and typically make plans and contracts based on the assumption that the regime will continue. Any major change will impose costs on their decisions, even if the change is

correcting a bad policy regime. Time and again nations have realized that grandfathering is good, meaning that existing contracts must be honored. Pre-announce the changes that will take place only for new contracts, and often only gradually over several years.

Competition is good: While economists carefully draw boundaries around the realm where competition and free markets should reign, economic freedom is our default setting. It is, after all, the economic counterpart of democracy. In specific settings, however, having the government as a competitor also improves efficiency, as will be noted below.

How ‘Broad is Good’ Works in Theory and History

Most economists prefer broad taxes, with lower rates and few loopholes. A majority of economists also seem to favor broad universalist expenditure programs. Their preference for breadth is not supported by any tight theorem derived from axiomatic principles. Rather it is their experience that tells them “broad is good.” The hunch is that we will minimize “deadweight costs” and GDP loss if we avoid narrow taxes or targeted subsidies that address one specific behavior, only to find that people overdo, or fail to do, something else. By going for broad and even incentives, we also avoid assuming that the government has enough information to micro-manage specific solutions. An environmental example is the case for broad effluent taxes as a way to reduce pollution. Similarly, economists’ call for a carbon tax is a call for a solution as broad as the problem. And cap-and-trade markets avoid presuming that the government knows just who should do the pollution cutting.⁶

Low Administrative Costs

While the argument that broad means better incentives remains just a good unproven hunch, one other advantage of broad universal taxes and social programs stands out clearly in the historical data. This is their lower administrative costs, both when collecting the taxes and when spending them.

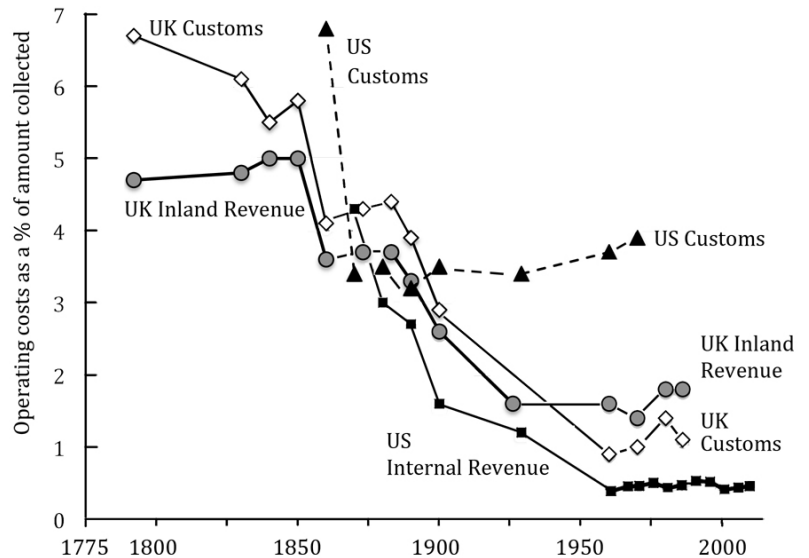
Since the 19th century, prosperity and democracy have allowed countries to economize on administrative costs by shifting from narrow taxes and transfers toward broad taxes and broad entitlements. On the tax side, history shows steep declines in the administrative cost shares of indirect tax collection across the 19th century and the early 20th, both in Britain and in the United States, as shown in **Figure 2**. In both countries, the cost of collections dropped, from over 4.5 percent of the amounts collected in the mid-19th century or earlier, to two percent or less since the middle of the 20th century. Economies of scale have cut the costs of bureaucracy, so that administering the U.S. Internal Revenue Service, for example, costs only 0.5 percent of the amounts collected.⁷

On the public social expenditure side, contemporaneous comparisons suggest that shifting from narrow and heavily policed social assistance to broad public entitlements programs has cut costs through economies of scale and the reduction in monitoring. Before 1880 European societies, intent on forcing all the able-bodied to work, tried to emphasize “indoor relief,” in which a person was kept in a poorhouse or workhouse. Its administrative costs were a high share, often 25 percent, of the total amount spent. Stricter regimes are more bureaucratic and more costly than universal entitlements.

By the postwar era, program-operating costs have fallen to almost-negligible levels in the high-income OECD countries. This applies not only to programs for the poor, but also the data on public pensions. International data on pension support programs show that administrative costs are less than 3 percent of the pension-program budget in all high-income countries, and often below 1 percent.⁸

In the health insurance sector as well, universalism lowers bureaucratic administrative cost shares. The best-documented contrast is the somewhat-more-private health care system of the United States, which has administrative and overhead (i.e. bureaucratic) costs far above those in the universal insurance countries of Canada and Germany on a per capita basis.⁹ One of the reasons is insufficient breadth of health insurance coverage.

Figure 2. Tax Collection Costs as a Percentage of The Amounts Collected by Central Government, US and UK, 1787/96 - 2011



Welfare States' Historic Performance¹⁰

Accepting economists' preference for broad taxes and benefits, and seeing the administrative cost saving of universalism, will prepare one for a historic result that still surprises some Americans. The welfare states of Northern Europe, with their social spending as high as 30 percent of GDP in some cases, have not suffered any clear net loss of GDP from it. So say decades of data on GDP and economic growth, with or without the use of econometric regression analysis. This is what I have called the "free lunch puzzle": large democratic welfare states, with universal entitlements, have not paid any net price in terms of economic growth or competitiveness, while following policies that delivered more equal incomes, less poverty, slightly higher life expectancy, and cleaner government relative to the United States or the average small-government economy.

While some may try to cite the problems facing Europe, the fiscal troubles of Mediterranean Europe and Ireland are unrelated to the welfare state. Rather, the Mediterranean countries deliver relatively little aid to schools or the poor, while over-protecting senior workers in older industries. Meanwhile, both Spain and Ireland have suffered mainly from the bursting of huge market bubbles in real estate.

The lack of any net GDP penalty from the whole welfare state package is not just a statistical finding. There are clear economic reasons for this outcome. The large-social-budget package has delivered enough economic growth advantages to offset any negative effect on GDP of work disincentives caused by generous unemployment compensation or higher taxation. Among those advantages are better health under universal insurance, better support for the development of mothers' careers, and a more pro-growth tax structure, with consumption taxes like a VAT. There is also an important political side-benefit of welfare states' having a flatter tax rate that pays for more universal benefits: the parts of the income spectrum that want social insurance

and human investments are paying for a large share of it. Beneficial human investment programs, and beneficial social insurance programs, are not dependent on victories in class warfare.

Translating such broad approaches into better ideas for financing social programs is easier for some categories than for others. Let us review the historical and economic wisdom of different kinds of social programs, and the taxation that supports them. Our review begins with policies for developing the young, and moves up the age ladder to policies toward the elderly.

Investing in the Young

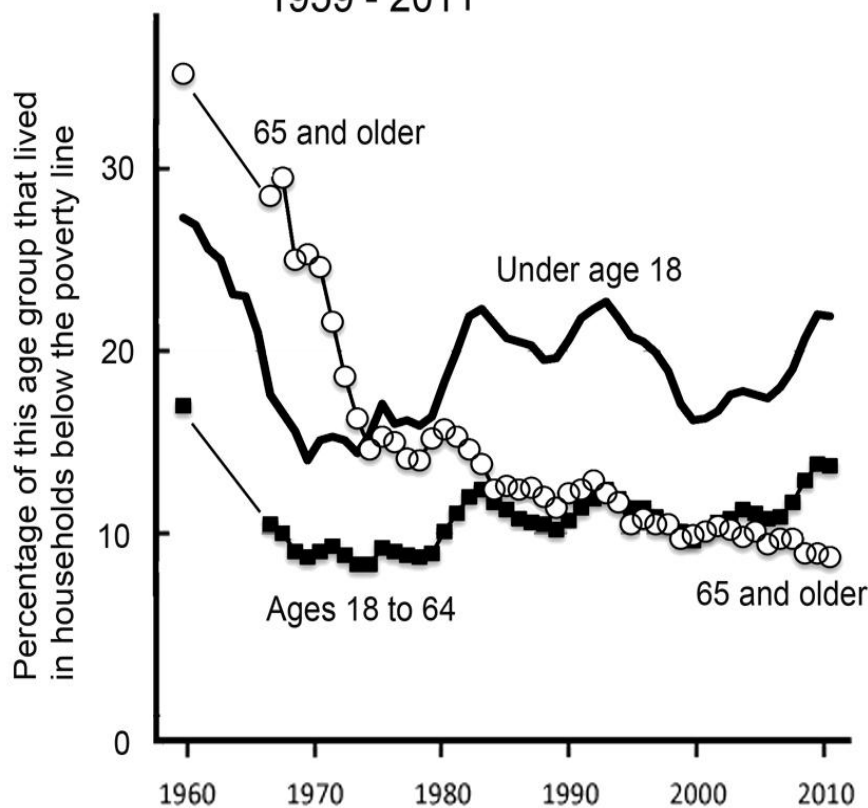
Stop the Mission Drift Away from the Young and the Poor

Our country and others have failed to do as much for the young as we have for the elderly. Ever since the late 1960s, when we installed the Social Security cost-of-living adjustment and shifted to a less pre-funded pay-as-you-go system, poverty among elderly Americans has plummeted, as shown in **Figure 3**. By contrast, poverty among children and those of working age marches on.¹¹

The decline in the share of elderly in poverty did not result from any changes in the private market economy. Rather, millions of

elderly were removed from poverty by the rise of political “gray power.” That the decline was policy-driven is clear from **Figure 4**. On its vertical axis Figure 4 shows the relative support for the elderly versus others, a double ratio equaling: (social spending on the elderly, per elderly person) / (social spending on the non-elderly, per non-elderly person). This elderly bias is not positively linked to large welfare states, like Denmark, France, and Sweden, as one can see along the horizontal axis. Rather, the elderly bias ratio looms large for four countries – Japan, United States, Italy, and Greece – each of which offers little to the poor by OECD standards. What makes these four countries stand out from the others is not generous pension support for the elderly, but rather the low levels of public support for children and working-age adults.

Figure 3. U.S. Poverty Rates by Age Group, 1959 - 2011



The Earlier the Human Investment, the Better

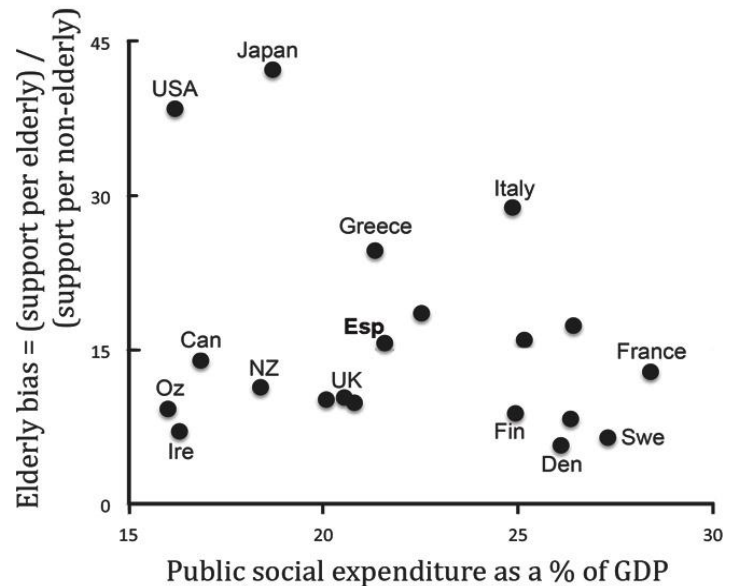
Our bias toward subsidizing the elderly runs against economists' insights and against any reading of the history of modern economic growth. Economists keep measuring the social rate of return on educating the young, and keep finding the rewards very high.

Historically, the countries that were the earliest to achieve modern economic growth were those whose leaders appreciated the case for raising taxes to pay for school. Even such free-market advocates as Adam Smith, Thomas Jefferson, and Milton Friedman appreciated the case for tax-based support for schooling. The northern states of the United States were world leaders in tax-financed public school enrollments in the nineteenth century, and led again in the high school wave of the twentieth century. The core economic reasons for turning to the taxpayers for school money are capital market imperfections (parents can't borrow privately against the prospective future earnings of their children) and the positive externalities from the extra knowledge and the civic engagement that schooling brings.

One pattern stands out clearly in the social returns to education: the younger the students, the higher the rate of social return to public funds spent. This result persists, both in the global literature summarizing the average apparent returns to schooling and in the deeper econometric literature based on American data.¹² Indeed, there is an easy way to rank the social rates of return on investments in different levels of schooling, either in this country or globally: pre-school > primary > secondary > higher education, with even the rates of return on higher education being as high as those on such alternative assets as long-term bonds.

At the top of the education pyramid, the urgency of raising public investment is the least, partly because we have a clear American success story. We have been world leaders in partially subsidizing higher education, going back to the Land Grant Colleges launched in 1862 and even to the colonial government subsidies to Harvard, Yale, and others. Yet the United States has always shown some finesse in higher education finance, giving only partial and egalitarian support and forcing its institutions to compete against each other. The support is partial and egalitarian to the extent that it features means-tested grants and loans. The goals of economic growth and equality are well served by means-tested Pell grants and loans, which can be thought of as higher-education vouchers for lower-income families. This country wisely avoids the next step taken by some countries in subsidizing higher education: we avoid guaranteeing free rides for well-off students whose private schooling makes them excel on national exams.

Figure 4. Bias toward the Elderly in Public Social Spending, 1985 - 2000



The competition is also crucial: higher education is a sector with sovereign consumers quite capable of shopping intelligently. The rising cost of college, led by persistently high returns to higher education, should not be seen as evidence of any lack of competition at the top. Berkeley, for example, faces tough competition – for good students, for good faculty, and for research grants – from its public-sector sister UCLA as well as from private competitors like Stanford. The competition is one reason that the United States completely dominates the world rankings, and is a heavy net exporter, in higher education.

At the bottom of the education pyramid, which we tend to focus less on, investing tax money in pre-school education remains more urgent on both efficiency grounds and equity grounds. Here is an opportunity for major productive expansion based on free choice among accredited institutions not controlled by large school districts, large unions, or any officially sanctioned religion. Note that the compelling case for tax financing of education is not a case for public *provision* of education. Economists have never seen a compelling reason for having the public sector dominate the supply of education services themselves, common as that practice may be.

As for primary and secondary education, the middle steps in the pyramid, our country continues to be among the leaders in quantity, though not in quality. We have always been a world leader in the number of years that an average youngster spends in school, despite a postwar rise in high school dropout rates. Yet we consistently fail to rank in the top 15 countries in terms of actual student curriculum learning, as measured in international tests such as PISA.

Would injecting more competition, more school choice, improve the quality of primary and secondary education? The fierce fight over vouchers cannot be resolved here. On the one hand, history speaks in favor of them where the status quo was abysmal, as it was when Cleveland and Milwaukee launched their limited voucher programs. Yet Chilean experience with vouchers has not been so positive, and the issue of what to do with the lowest quality schools has no simple resolution and is deeply intertwined with other welfare issues like poverty.

Whether the nation goes with vouchers or just with freer choice within the public school system, two side-points need emphasis here. First, greater parental choice of schools brings gains even if it does not improve aggregate school performance. Economists recognize a gain in wellbeing just from allowing dissatisfied parents to change their children's schools. Second, conservatives in favor of vouchers would need to accept the political reality that tax money would not go to private schools without heavy government regulation of a generally secular curriculum, as is practiced in the Netherlands and other European countries allowing the subsidies to extend to schools run by organized religions.

Welfare as We Have Come to Know It

A straightforward broad strategy for fighting poverty has remained popular among American economists since the 1960s. In 2009, fully 79 percent of economic experts agreed that “[t]he government should restructure the welfare system along the lines of a ‘negative income tax’” such as the one advocated by Milton Friedman, Robert Lampman, James Tobin, and many others. With a negative income tax, we tax everybody's income at a flat percentage and give the revenues back to everybody in equal dollar amounts based on family size (a tax rebate or “demogrant”) and whether they are rich or poor, so that the poor pay a negative income tax. Aside from a broad low work disincentive, the negative income tax does not mess with the marketplace. It avoids subsidizing family farms, building public housing, or legislating minimum wage rates, all of which are costlier

distortions.¹³ Given its bipartisan appeal among economists, we might easily settle on the negative income tax as a prescription for a larger social contract; however, the idea of a negative tax remains viscerally unpopular with many Americans.

Since 1993 an alternative approach has mustered bipartisan political support, and some theoretical support among economists. That year's expansion of the Earned Income Tax Credit (EITC) subsidizing work among lower-wage earners, and the 1996 Personal Responsibility and Work Opportunity Act (PRWORA) setting strict limits on welfare for those out of work, "ended welfare as we know it," in the words of President Clinton. Support for those out of work became much less generous, while work became subsidized up to a certain "phase-out" range of earnings, beyond which one rejoined the usual taxpaying ranks. The new combination of work subsidies and workfare toughness continues to draw bipartisan political support, aside from a brief Tea Party attack on the EITC in 2011. The negative income tax idea is history, it would seem.

What are the respective merits of the alternative approaches? Some economists have theorized that the EITC may have raised employment, reasoning that by drawing people initially into low-paid employment, it gets them on a career path they will not leave later when their earnings rise to enter the high-tax phase-out range.¹⁴ Others question whether there has been enough net employment gain to justify the regressivity of the EITC-PRWORA package relative to a negative income tax.¹⁵

A major test came in the Great Recession of 2008-2009, when a large share of the poverty population was no longer entitled to cash welfare. Studying this recent harsh test case, Marianne Bitler and Hilary Hoynes have found that the remaining combination of safety nets seemed to take up much of the slack left by the expiration of cash assistance to poor families. Food stamp benefits proved more quickly responsive to the new hardship than in earlier slumps, and the Great Recession did not show any extra damage in terms of such outcomes as health or household crowding. On the other hand, a given unemployment rise did mean a significantly greater rise in overall poverty after the PRWORA reform than under the older regime.¹⁶ Thus the tidier negative-income tax approach preferred by most economists still looks like the more effective short-run anti-poverty safety net, despite some offsetting responses from food stamps and medical aid. To reduce poverty rates over the longer run, so that we at least approach the lower OECD average poverty share, we need greater investments in human capital, on the education and health fronts.

Paying for Health Insurance

The health sector in the United States will be perennially problematic because of its peculiar economics. Thus it has been for the last century, thus it is now, and thus it shall be. The main reason why these problems absorbed less attention before the early twentieth century was that medical care was so ineffective. Only in the last hundred years have we seen an explosion of successful, and very costly, health technologies. The demand for health care has soared with good reason, especially when the patients and providers could get someone else to pay for it. The rise in demand will surely continue, as technology keeps improving and the population gets richer and older.

The battle to contain costs while assuring quality will never end, given the overwhelming informational complexity of health care and the fact that within the current system this sector is riddled with market power on the part of providers and insurers. International opinion surveys have never turned up a country where people are enthusiastic about their health care sector, and Americans tend to have more complaints than the international average.

There never will be a formula that allows the public to relax and ignore the health care sector. Nor, in the face of aging, is there a pension-style formula that puts just the right ceiling on care for the elderly. All that can be offered here are two guidelines for reshaping cost control in health insurance.

Broad is Good in Health Insurance

Health insurance is less costly if coverage is mandatory and supplied by either a single payer or a single regulator setting rules for competing insurers. Such a broad approach is superior in health insurance because of the informational structure of health care. Having a central insurer, usually the government, cuts administrative costs, as we have already noted.

Doing so also addresses the “asymmetric information” problem with voluntary private insurance. Insurers know less about a customer’s health prospects than does the customer. Thus when insurance is voluntary, those who suspect they are in poor health are more likely to enroll. This sets up the famous “voluntary insurance death spiral”: the self-selection by high-risk customers forces the insurer to raise premia, which induces healthier customers to flee, leaving an even higher-risk residue of customers, which leads to further premium hikes, and so on until the insurance plan disappears.

To avoid this spiral, private insurers seize upon whatever information they can get that justifies denying coverage to those with previous conditions. The problem of asymmetric information is more severe in health insurance than in other insurance sectors. Auto insurance, for example, takes advantage of the fact that key predictive information about the customer, such as age or driving record, is in the public realm. Insurers have also tried to raise profit margins by exploiting complexity to delay or deny a certain share of claims. The Patient Protection and Affordable Care Act of 2010 (Obamacare) took steps to limit such practices, with partial success.

America has yet to accept the insurance solution that has worked relatively well in other countries: let the government serve as a dominant payer, with mandatory universal coverage and mandated pure community rating. (Note that international experience recommends single-payer *insurance*, but is indifferent to government *provision* of health care.)¹⁷ Instead, American state and federal insurance systems embody an unavoidably messy political compromise, one in which the public is forced to buy coverage choosing from a menu of private insurers. As it stands, the government will act as single regulator, not as single payer. This has the political advantage of keeping government budgets from raising taxes to cover insurance, but the disadvantage of perpetuating, and still subsidizing, a costly private insurance industry.

Liberate Health Insurance from Jobs, and From Elderly Bias

American health insurance is dominated by plans negotiated by employers. There is no economic logic to this. Why should health insurance have anything to do with one’s current job? The cheapest way to pool insurance customers at a low informational cost would be to pool the entire population, using national health statistics to define the probabilities of claims. Using employer-based pools has three defects in the American case: employer-specific coverage is not portable for those who change (or lose) their jobs; taxpayers have to subsidize the coverage; and to the extent that its extra costs exceed the tax subsidy, employer-based coverage makes American businesses more costly and less competitive.

Why are employer-based plans so dominant in this country? At the center of the problem is a series of historical wrong turns. Employer-based plans gained popularity in World War II, when wage controls prevented employers competing for scarce workers by offering higher straight pay, but allowed them to offer attractive fringes. Then came a tax policy, enacted in 1943 and solidified in a 1954 Supreme Court ruling, which exempts employer contributions to employee health plans from taxation, either as corporate income or as employee income. Thus one major reform left undone by the Congressional fight of 2010 is the removal of special subsidies on employer-based health coverage to push the industry toward offering plans that are more portable from job to job.¹⁸

Another needed reform is to liberate public (alias “socialized”) health insurance from its costly confinement to those over 65 (plus the military). This restriction was forged in another costly wrong turn. The passage of Medicare in 1965 was targeted at the elderly because they rightly feared facing costlier health care with no job to offer them coverage. Some have tried to reduce this elderly bias by extending Medicare to all age groups. In 2010, Obamacare succeeded in extending insurance toward the young, with extensions of Medicaid and the State Children's Health Insurance Program. It thus made partial steps toward making coverage more universal, while proceeding slowly enough to honor (to “grandfather”) existing insurance arrangements. Yet one's 65th birthday still brings a jump in coverage, and this country's deficit in life expectancy among OECD countries is still worse before the age of 65 than after that birthday.¹⁹

Sustainable Pensions

We turn next to the kind of social program that lends itself most easily to the use of broad formulae to solve an undeniably big problem.

Something Has to Give

Today for every 100 Americans of working age (18-64 years) there are 35 elderly Americans (65 and up), most of them retired. By the year 2050 there will be 49 elderly for each 100 Americans of working age, assuming today's rates of birth, migration, and survival. The balance between people paying into retirement and people drawing on it is shifting. So we are warned in the media every week. Social Security currently costs 5.0% of GDP, but spending will have to rise to 6.2% of GDP by 2037.²⁰ Actually, the ratio is likely to shift even faster than that, because of a newly documented “longevity transition”: The life expectancy of seniors is shooting up rapidly, presenting all pension calculations with a possible curse of unexpectedly long life.²¹

This demographic fact of life has a clear implication for setting pensions:

*As the share of elderly rises, their annual benefits past the age of 65 absolutely cannot rise as fast as the average incomes of those of working age.*²²

This clear warning is both softer and louder than it may sound at first. Softer, in the sense that it does not mean your pensions have to drop in real purchasing power. Pensions should still keep up ahead of the cost of living – it's just that they cannot grow as fast as earned incomes per person of working age, which historically grow at about 1.8 percent a year, adjusting for inflation.

Yet the warning should sound louder when one realizes that it applies to the future of *any* kind of provision for old age, no matter how private or public. The curse of longer life is not specific to Social Security or other public pensions. It is the same

even if you relied only on your own savings for old age. To plan ahead, if you live to age 65, you are likely to live to 85 even at today's survival rates. Your grandfather only had to plan on living about 14 years more, if he were to reach age 65. Even in such an individualist calculation, your annual consumption in retirement has to be a lower share of annual earnings than in the past, because you'll live more years. So it's not a problem of government pensions, but a problem facing *any* pension plans, be they individual savings, private job-based pensions, or Social Security.

Formulas that Work for Social Security

Fortunately, there are broad formulas that can adjust our pensions to longer life spans. Here are three formulas that would make Social Security sustainable indefinitely, formulas that private savings plans should also try to emulate.

The first formula is one on which the United States has already done its homework quite well, and just needs to follow through. The formula is this:

Keep the share of adult life spent on Social Security from rising, by extending the working age for each benefit in proportion to the average adult life expectancy of people with similar career histories.

The United States has already taken steps down this path, thanks to the 1983 Greenspan Commission on Social Security Reform. We have advanced the age of "full" retirement benefits from 65 to 67 for those born after 1960. The gradual formula adopted in 1983 follows the strategy of "grandfathering is good" by not hitting those of middle age with a shock to their life plans.

Yet the news about accelerating senior longevity means we must continue. Seniors are increasingly healthy, and the share of them in poverty has declined, so it is not unreasonable for them to receive full Social Security benefits only if they work the same share of their adult lives as did their parents. Fixing the share of adult life at work would mean something like this: to receive the year 2007's retirement benefit as a percentage of average earnings at any given age, one must work 51.6 percent of one's life expectancy for males, and 41.5 percent for females, as we did in 2007. America's progress along this path needs to continue, with more age adjustments.

The second formula builds in an automatic adjustment of the work-retirement balance to the longevity trend. Borrowing from the "notional defined contribution" pension reform that Sweden set up in the 1990s, the formula is this:

Index the retirement benefits for each cohort to life expectancy at age 60 for persons of given earnings histories.

That is, while every individual's annual pension benefits are still tied to his or her lifetime earnings history, they are indexed to the senior survival odds of people in his or her birth cohort. Thus if you were born in 1980, and you worked from 2000 to 2045, your Social Security benefits would be tied to your earnings over those years divided by an index that is tied to the age-60 life expectancy calculated from survival outcomes around the year 2040. The longer your cohort of people is expected to live, the less your benefits each year, though of course your benefits are likely to continue for more years. This helps maintain aggregate balance in the pension budget. An extra twist for the United States is one that Sweden didn't need. Since American senior life expectancy is shorter for persons with lower lifetime earnings, avoiding regressivity in the pension formula requires tracking the

senior life expectancy of persons in different career earnings ranks. Making that adjustment is not difficult, given the Census Bureau's mortality data and Social Security's career earnings data.

The third formula is also patterned after Swedish practice since the 1990s:

*Index annual pension payouts to recent GDP per working-age person.*²³

Pensioners' benefits from Social Security should share in the fortunes of the economy. When there is a boom, pensioners share in it, by automatic formula. By the same formula, pensions share the pain of a recession as much as others. In an unlikely Great Depression extreme, their ultimate safety net would be the same as for the young: public support for the poor plus medical care.

Pre-commitment to such pre-determined formulae could remove the pension parameters from the political arena. Of course, social contracts can only make political pre-commitment easier. They cannot guarantee it. Even Sweden softened its pre-set formula very slightly in response to the 2008-2009 slump. Under the original formula, the government was obligated to cut benefits for the two years 2010-2011. Afraid to follow through on the cuts in 2010, an election year for Parliament, officials changed the formula to stretch the reductions out over more years. Yet the system remains intact, and it still works.

Which Taxes Pick Up the Rest of the Tab?

The changes in social programs just sketched imply greater expansions of government expenditures than revenue contributions internal to these same reforms of pensions, education, health insurance, and welfare programs. The net extra expenditures must be covered by more general taxes. Specifically, the tab includes these expansions, in order of expenditure urgency: improving and expanding public education, with an emphasis on the earlier years; deficit reduction, once recovery from the 2008-2009 recession is fully under way; and universal government provision of health insurance for citizens under 65.

What taxes should pick up the tab here? First, here are two types of tax changes that are not needed: We may not need any new taxes or contribution increases for Social Security. There seems to be sufficient time to install the formulas for pension sustainability. There is also no strong case for changing direct taxes from what they were in the Clinton boom of the late 1990s, an era that produced budget surplus. For all the talk of the complexity of the income tax structure, its administrative costs are low. Let the Bush tax cuts expire for high incomes, for capital gains, and for inheritances, slightly reducing the deficit.

Addiction Taxes

As for new or expanded taxes, the two best candidates are addiction taxes ("sin taxes") and the value added tax (VAT), two types successfully applied in virtually all industrialized democracies outside the United States.

The United States is a laggard in taxing three addictive goods that cause serious negative externalities: alcohol, tobacco, and gasoline. The first two are private addictions with obvious health externalities. The third is a collective addiction leading to pollution and climate change as well as to dependence on oil imports from hostile suppliers.²⁴ As **Figure 5** shows, the United States charges so little tax on gasoline at all levels of government that our overall gasoline prices, per liter or per gallon, are only

half those of the average industrialized country. We even tax it less than Canada and Australia, two other countries with long travel distances. The resulting high rate of gasoline consumption per capita helps make the United States, along with China, the world's worst contributor to greenhouse gases and other airborne pollutants. There is a strong case for raising federal gasoline taxes over the next decade. To be sure, the amount of increase that would cut our emissions to the average OECD level will not necessarily equal the amount needed for the right budget balance, but the direction in which gasoline taxes should move is clear. The other two sin taxes, on alcohol and tobacco, could also be raised toward the OECD average.

The VAT

A European-style credit invoice VAT is the other most appropriate broad tax for filling revenue needs, as long as it is funding worthwhile expenditures that are more progressive than the VAT itself.

What needs emphasis here is that the whole American debate has been discussing the wrong context for a new VAT. Postwar U.S. discussions have presumed that the VAT must be a substitute for income taxes and other current taxes, in order to lower administrative costs as a share of the amounts collected. This presumption has a factual error, and has a redistributive character that should continue to doom the tax-replacing approach to the VAT.

The common assumption that the appeal of the VAT depends on its having lower administrative costs than the direct taxes it would replace is wrong. Direct federal taxes already have a low administrative cost as a share of the amount collected, as we saw in connection with Figure 2. A VAT should supplement the existing direct tax structure (at its Clinton-era tax rates), rather than replace it, and can do so without any jump in administrative costs.

The fixation on using a VAT to replace other taxes has always been so blatantly regressive as to doom the VAT each time it was introduced into Congressional committee. Democrats saw the regressivity, and Republicans saw a new tax. What made the European pioneers so successful in introducing and expanding the VAT was using the revenues to fund such progressive programs as universal health insurance and education.

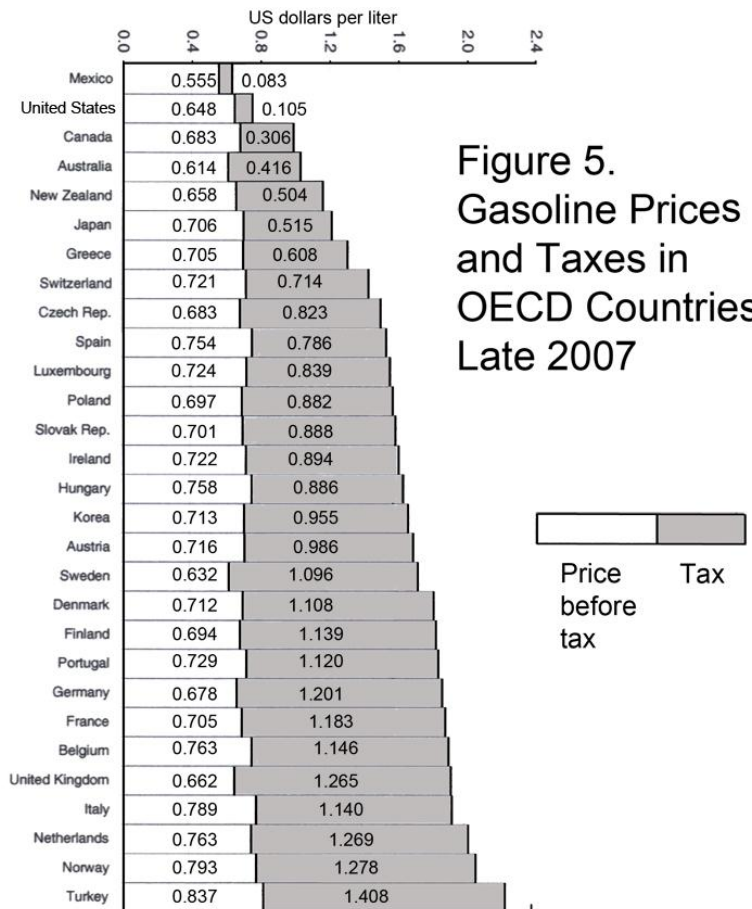


Figure 5.
Gasoline Prices
and Taxes in
OECD Countries,
Late 2007

They Are Not Regressive

Another error commonly made about the VAT is the regressivity argument: “Wait, it’s regressive – it takes a bigger share of income from ordinary working folks than from rich people.” People base this claim on the fact that the taxed consumption would represent a bigger share of the current household incomes for the poor than of the incomes of those who are better off and able to save more to avoid the consumption tax. This is the prevailing American wisdom, something that “we all know,” and it is wrong.

One cannot say whether or not the consumption tax is regressive until one says what is done with the extra tax revenue. The consumption tax could easily be *progressive*, and actually tends to be progressive in some of the countries that rely heavily on it today. One way to make it progressive is to spend it progressively, with the share of benefits declining with income. For a simple and extreme example, suppose that we had a flat 15 percent consumption tax (VAT), and used the revenues to give a \$5,500 entitlement to every person, or \$22,000 per family of four, approximately the poverty threshold for a family of four. If your four-person family consumption were below \$146,667 (which = $\$22,000 / 0.15$), you would receive more than you pay in consumption tax. The more your consumption exceeded the \$146,667, the more your consumption tax would exceed your flat benefit, and the more you would pay to others. The result is clear “progressivity,” defined as a rise in net taxation as a share of income as income rises. Something like this happened when Sweden introduced the consumption tax in the 1950s with the explicit main purpose of funding universal public health insurance.

Even if the unspoken assumption is that we are comparing a consumption tax (VAT) with a fixed percentage tax on all incomes, instead of a flat entitlement, the consumption tax is not necessarily regressive. People usually think it is, reasoning that a consumption tax is proportional to consumption, which declines as a share of income as income rises. Ergo it takes a higher percentage from low incomes than from high incomes.

The fallacy here is to assume that the part of income that is saved avoids the consumption tax. On the contrary, the saver and his or her heirs will actually pay the consumption tax in the future, since the consumption tax is probably permanent. As long as the rate of discount applied to future consumption is the same as the rate of return on savings, the net present value of the taxes paid will be the same, whether you consume now or you consume later. Again, one must take a clear look at the alternative before announcing the effect of a particular tax.²⁵

The Contract and the Challenges

The daunting challenges facing any such social contract are all too familiar. For all the desirability of welding the tax and expenditure sides of a contract together, the political process can be unkind to solemn attempts to pre-commit competing sides to a long-term agreement. Some pre-commitments have indeed been carried off, when implemented gradually. Two good examples were the Greenspan Commission’s 1983 fixing of the advance of full-benefit retirement ages, and the pension index mechanisms still built into Sweden’s notional defined contribution system. But binding pre-commitments have failed in the past. Remember Gramm-Rudman, the balanced budget amendments, and other rules aimed at constraining the whole budget? Without bipartisan appeal, Presidential commitment, and Supreme Court approval, social contracts will fail.

Another challenge is historical “path dependence,” a historian’s way of saying that where you can go is constrained by where you are now. Our history has driven us into some sand traps, such as the double exemption of premiums paid on employer-based

health insurance plans, the deductibility of mortgage interest, and California's infamous Proposition 13. To follow through on the golf metaphor, history does not allow mulligans. The wisdom of hindsight about past mistakes helps only a little, and reforms must be incremental.

One implementation tactic that can help a little is to time the bundles of reforms so that accounts balance along the way. Thus one can envision a Wave 1, over a decade or less, in which the social contract targets the most urgent expenditures – the expansion of public funding for education, with reforms promoting competition and choice, plus some post-slump deficit reduction. Wave 1's revenue increases can easily include sin taxes and the introduction of VAT at a low rate. A later Wave 2 can expand the generosity of anti-poverty aid, lowering our poverty rate to the OECD-30 average, and phase in government-financed health insurance to lift the burden on employers. These second-wave expenditure targets must again be progressive enough to keep the whole package progressive as the VAT expands, as it has slowly done in other countries.

Such a sequence would not be achieved easily, but it is consistent with the goals and strategies of social contract reform: promoting growth, doing no net harm to the poverty population, and reducing deficit shares, and doing so through breadth, addressing externalities, gradualism, and competition.

Notes

¹ Aggregate material wellbeing here means the well-known Measure of Economic Welfare (MEW) proposed by William Nordhaus and James Tobin in 1972 (Nordhaus and Tobin, *Is Growth Obsolete?* New York: Columbia University Press). It adjusts gross domestic product by putting values on free time, length of life, environmental quality, and other aspects of wellbeing not captured by annual GDP. Still, one can often refer to GDP as though policies raising it also raised the MEW. Note that the Nordhaus-Tobin MEW does not put a value on income or wealth equality. Reducing inequality is a goal that must be weighed separately.

² Defining the poverty threshold as one-half the median household income, the United States had 17.1 percent of its population in poverty as of the mid-2000s, versus an average poverty rate of 10.6 percent for 30 OECD nations. Of the 30 countries, only Turkey and Mexico had higher poverty shares than the U.S. (OECD 2008, Ch. 5, esp. p. 127).

³ Figure 1's estimates are from Wang *et al.* (2012). For similar results, and for international comparisons of relative poverty, see the OECD *Growing Unequal* study (2008). International comparisons of absolute poverty are found in studies by the Luxembourg Income Study: See Smeeding *et al.* (2000), and Scruggs and Allan (2005). For a readable and balanced summary of the issue of "vertical equity" and the case for progressivity in redistribution, see Slemrod and Bakija (2004), especially Chapter 3.

⁴ Among the Chicago Business School's IGM group of economic experts, 90% agree that fiscal policy (e.g., tax cut and/or government expenditure increase) has a significant stimulative impact on a less than fully employed economy. Further, 85% agree that if the federal budget is to be balanced, it should be done over the business cycle rather than yearly. And 83% agree that a large federal budget deficit has an adverse effect on the economy, but without any definitions of "large" or "adverse" or the relevant time frame.

⁵ Some issues must be set aside here, either because economists recognize that truth is nuanced or because they agree only that moderation is optimal, without being able to quantify the optimal moderate level. Here are three issues on which Harry Truman's famous search for a one-handed economist should be abandoned:

- (1) *The choice between centralized and decentralized government.* This is a sub-branch of economics full of nuanced results, whether the subject is the level of government that raises revenue, or the level that does the spending, or the level having control of allocation. On the one hand, centralization can bring economies of scale and can smooth away incentives for inefficient flight from taxes and control. On the other hand, local control offers better monitoring in response to local needs and local political tastes, offering the advantages of free competitive shopping among local governments.
- (2) Also omitted, because history does not support a simple rule, is any clear stand on *bailouts and bankruptcy for business sectors*. The tension between the insurance principle and moral hazard concerns has no simple formula solution. History finds too many cases on both sides.
- (3) Let us also set aside the economics of *staple public purchases* such as national defense, infrastructure, and other budget categories for which the case for collective action and for sharing finite "moderate" budgets is more obvious and less controversial.

⁶ On the environmental front, for example, 78% of the economic experts surveyed by the Chicago Business School agreed that "Effluent taxes and marketable pollution permits represent a better approach to pollution control than imposition of pollution ceilings."

⁷ The sources for Figure 2 are the IRS *Yearbook* and the sources cited in Lindert (2004, vol. 1, p. 304). The low cost share for the IRS omits the cost to taxpayers of preparing their income tax forms each year.

⁸ The administrative costs for the US Social Security Administration were 1.6 percent of benefit payments in fiscal year 2012, and are projected as 1.4 percent for fiscal 2013. See www.ssa.gov/budget/2012KeyTables.pdf, Table 9, and similar for 2013. For the late twentieth century, see Estrin, Alexander, 1988. “Administrative Costs for Social Security Programs in Selected Countries,” *Social Security Bulletin* 51, 88: 29-31. For the usually higher cost shares of less universal assistance programs in the early twentieth century, see Gordon, Joel. 1940. “Comparative Costs of Administering Public Assistance: An Analysis of the Administrative Expenses of 28 Public Assistance Agencies during 1938-39”. *Social Security Bulletin* 3, 2 (February): 11-20.

⁹ Woolhandler *et al.* (2003, especially p. 771), Reinhardt (2000), Cutler and Ly (2011).

¹⁰ This section draws on Lindert (2004, especially Chapters 1, 10-12, and 18) and Allard and Lindert (2007). The reference to competitiveness is to World Economic Forum (2012). The reference to cleaner government is based on Transparency International’s business-based “corruption perceptions index”, which consistently ranks Nordic countries and Switzerland at the top.

¹¹ Source for Figure 3: United States Census Bureau, “[Historical Poverty Tables](#),” accessed 29 September 2012. Source for Figure 4: Lynch (2006). For similar figures covering 1980, 1985, and 1993, see Lynch (2001). Lynch’s numbers include public education spending, unlike the OECD data on social expenditures.

¹² The global average return studies are summarized by Psacharopoulos (1994, 1996). The econometrics of returns to early education is presented by Heckman (2000), Carneiro and Heckman (2003), and Carneiro and Ginja (2012).

¹³ For a quick introduction to the history of the negative income tax idea, see Moffitt (2004). For Friedman’s classic statement, see *Capitalism and Freedom* (1962, pp. 190-195). We should note that while Friedman popularized the idea, his version of it was not so generous. His offering a hypothetical \$300 per person was far below the 1962 U.S. poverty line of \$1,245 for an unrelated individual.

¹⁴ Diamond and Saez (2011, p. 176).

¹⁵ Moffitt (2004).

¹⁶ See Bitler and Hoynes (2010), and the broader survey of welfare program results in Ben Shalom *et al.* (forthcoming).

¹⁷ In health care as in education, there is no case for government *provision*. Government-supplied health care works well enough in England and Wales, but no better than in other countries where government centrally finances the insurance, and not the provision, as in Germany or Canada.

¹⁸ Thomasson (2002, 2003).

¹⁹ Eggeston and Fuchs (2012).

²⁰ “The 2012 Long-Term Budget Outlook,” Congressional Budget Office, 2012, Table 4-1.

²¹ On the recent acceleration of senior survival rates, see Eggleston and Fuchs (2012).

²² This result is derived from a budget balancing equation in Lindert (2004, vol. 1, pp. 195-196).

²³ I have oversimplified Sweden's system, which is well described in Knuse (2010). Instead of an index tied to GDP per working-age adult, Sweden uses two other index factors that yield a similar result. The economic aggregate is wages and salaries per employed person, not GDP per person 18-64. And Sweden backs up its pension stability with an additional trigger that goes off whenever the pension fund's "Balance ratio" $BR = \text{capitalized assets} / \text{capitalized obligations}$ drops below 1.

²⁴ For an international comparison of the rates of all three kinds of sin taxes in the mid-1990s, see Lindert (2004, vol. 1, pp. 242-244). Figure 5 updates the gasoline tax rates, drawing on International Energy Agency (OECD), *Energy Prices & Taxes*, 4th Quarter 2007, Figure 8.

²⁵ And symmetrically when the usual analysis mistakenly associates a particular public *expenditure* with the poor or the rich. Subsidizing public elementary and secondary school might seem progressive, since the beneficiaries are not the elite. Yet if the schools were paid for by a poll tax or a tax on staple foods, they could deliver a net cost to the poor and a net benefit to the rich.

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